

1. The concentration of wireline long distance services has declined dramatically in recent years.

20. According to FCC data, AT&T accounted for roughly 55 percent of long distance revenue, 59 percent of long distance minutes and more than 65 percent of subscribers when the FCC concluded it was not dominant in 1995.¹⁵ The next largest carrier at the time, MCI, accounted for 17 percent of long distance revenues -- roughly 30 percent of AT&T's.¹⁶

21. Since that time, AT&T's share and industry concentration has declined rapidly. Nonetheless, AT&T remains, by far, the nation's largest provider of long distance services. The FCC reports that as of 2001, the most recent data available, AT&T's share of long distance toll service revenue was 37 percent.¹⁷

22. The share of long distance subscribers served by BOCs has been growing rapidly due to the expansion of the number of states in which long distance service has been authorized (and BOCs' success in obtaining new customers). As of June 2003, BOCs have received approval to provide long distance service in 43 states (and Washington, D.C.), which account for more than 80 percent of BOC lines.¹⁸ As shown in Figure 1, BOCs together combined for an estimated 10 percent of wireline long distance subscribers in 2002. This share is projected to increase to 17 percent in 2003 and 26 percent in 2005, following the expected expansion of BOCs' authority to provide long distance service in the remaining states.¹⁹

15. AT&T Non-Dominance Order ¶67 (citing 1994 data).

16. FCC, Long Distance Market Shares Fourth Quarter 1998, March 1999, Table 3.2.

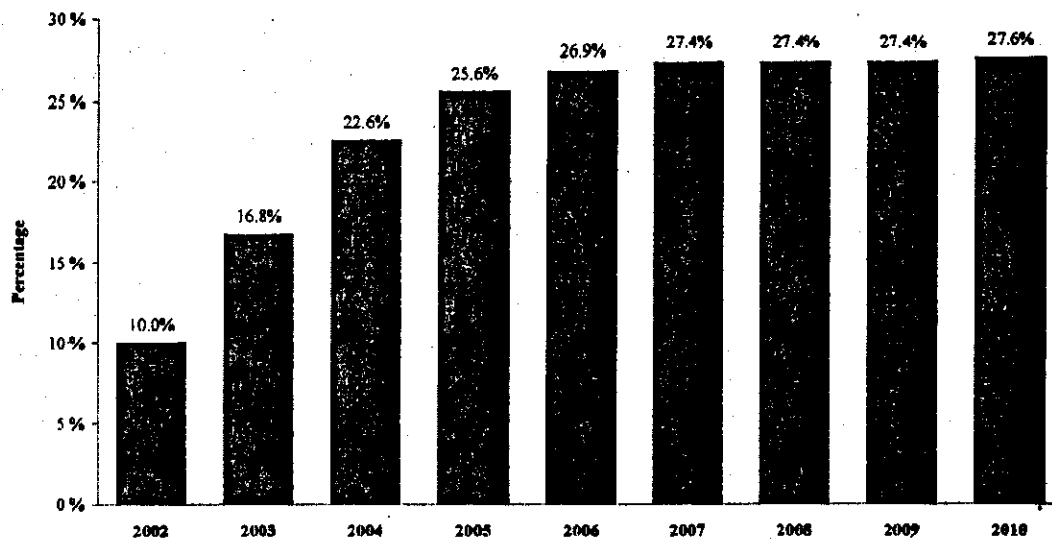
17. FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 7.

18. *Id.*, Table 12, and FCC, Qwest 271 Order for Minnesota, FCC 03-142, June 26, 2003.

19. These figures reflect BOCs' share of all wireline subscribers, which include subscribers of CLECs and independent ILECs. Deutsche Bank estimates that BOCs' share of their own local service customers will reach roughly 38 percent in 2005. Deutsche Bank, "Wireline -- Mid Year Review: Last Man Standing," May 27, 2003, p. 143, 157, 168.

Figure 1:

**Projected Combined RBOC Shares of Wireline Long Distance Subscribers
2002 - 2010**



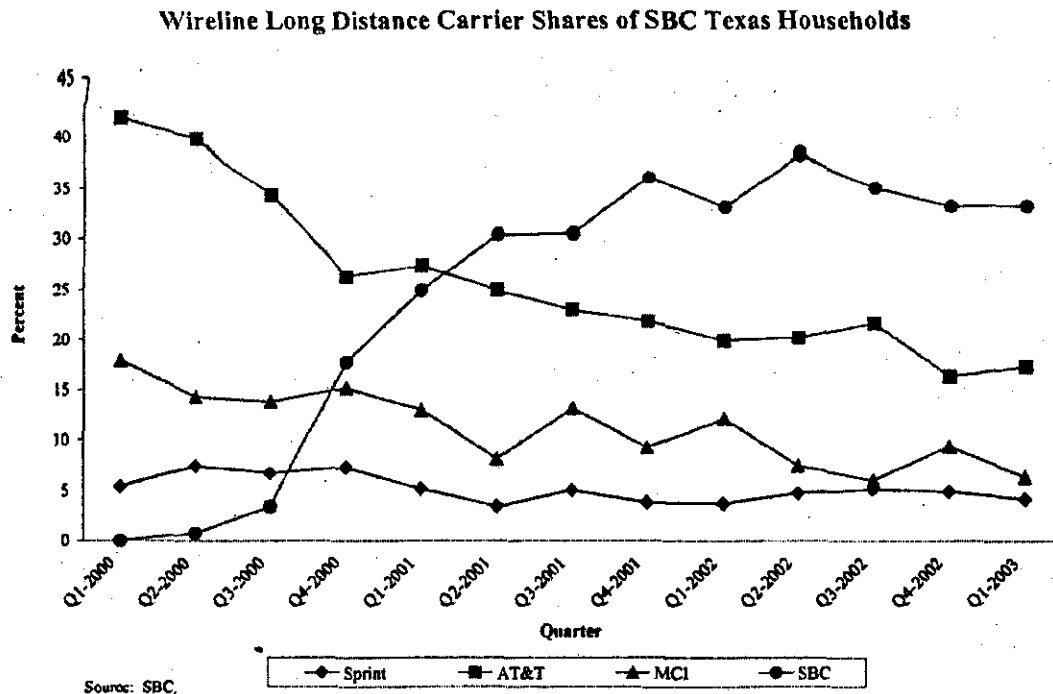
Source: Deutsche Bank, Wireline - Mid Year Review: Last Man Standing, May 27, 2003, p. 185.
Note: 2003-2010 are forecasts.

23. After that date, however, little further growth in BOCs' share of wireline long distance subscribers is anticipated. This is consistent with evidence from states in which BOCs have already entered which indicates that "[t]he experience (thus far) of the RBOCs getting into new markets has been one of significant initial market share gains and then relative stabilization within 18 months of entry."²⁰

24. The rapid growth and subsequent stabilization of BOCs' share following 271 approval is shown in Figure 2, which reports changes in the shares of households served by major long distance carriers in areas of Texas served by SBC following SBC's 271 authorization in June 2000. As the figure shows, SBC's share in its regional footprint went from zero to roughly 35 percent by the fourth quarter of 2001 and has been roughly stable since that time.

20. Deutsche Bank, "Wireline - Mid Year Review: Last Man Standing," May 27, 2003, p. 35.

Figure 2:



25. While Figure 1 reports BOCs' combined share of long distance subscribers, it can also be interpreted as an approximation of the average BOC share in a given region, since only one BOC operates in a given area. Thus, the data imply that, in any given region, BOCs will account for a substantially smaller share of wireline long distance subscribers than AT&T did in 1995. Calculation of BOCs' shares in this way, however, does not necessarily imply that geographic markets for long distance services are regional. Factors such as geographic price averaging requirements and the ability of BOCs to enter out-of-region suggest that the geographic scope of the market may be broader.

26. Even if shares and concentration are calculated on a regional basis in this way, the data reveal dramatic declines in wireline concentration and further show that BOCs' expected share is well below AT&T's national share in 1995, when it was declared to be non-dominant. As shown in Table 1, measured on the basis of the average BOCs' expected in-region share of presubscribed lines, the concentration of the wireline long distance industry has fallen

dramatically since 1995. The Herfindahl-Hirschman Index (HHI) for wireline long distance providers (in a given region) is expected to decline to roughly 1500 in 2005, far below the level of roughly 4700 that prevailed in 1995.²¹ If each BOC's national share is used in the calculation, the HHI falls to about 1,100. These figures also implicitly exaggerate shares and concentration by not accounting for long distance traffic carried by wireless firms (as well as ignoring the impact of e-mail, instant messaging and other forms of "intermodal" competition).

Table 1:

Long Distance Presubscribed Wireline Shares and Approximate HHIs

Year	AT&T	MCI	Sprint	Combined RBOCs	Others	Regional HHI ¹	National HHI ²
1995	66.4%	15.7%	6.4%		11.5%	4,708	4,708
2005	24.4%	14.2%	5.1%	23.6%	30.7%	1,509	1,060

Source: FCC, Long Distance Market Shares Fourth Quarter 1998, March 1999, Table 2.2 (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/LAD/mksh4q98.pdf) for 1995 data; Deutsche Bank, Wireline Mid-Year Review: Last Man Standing, May 27, 2003, pp. 185, 143, 157, 168 for 2005 data.

Notes: HHI calculation treats "others" as group of 1% firms.

1/ Regional HHI based on assumption that each RBOC's 2005 share is equal to RBOCs combined national share.

2/ National HHI based on each RBOC's expected nationwide share (Verizon 9.8%; SBC 9.3%; BellSouth 4.0%; Qwest 2.4%).

27. Moreover, the disparity in the number of subscribers served (in a given region) between BOCs and other carriers that is expected in 2005 is much smaller than when AT&T was declared to be a non-dominant carrier in 1995. As noted above, AT&T's revenues were more than three times as large as its next largest rival at that time. The Deutsche Bank forecasts for 2005 indicate that AT&T is expected to account for 27 percent of industry gross toll revenue (which includes long distance, intraLATA toll and private line revenue), BOCs' (combined) will account for 19 percent, MCI will account for 14 percent and Sprint will account for 7 percent.

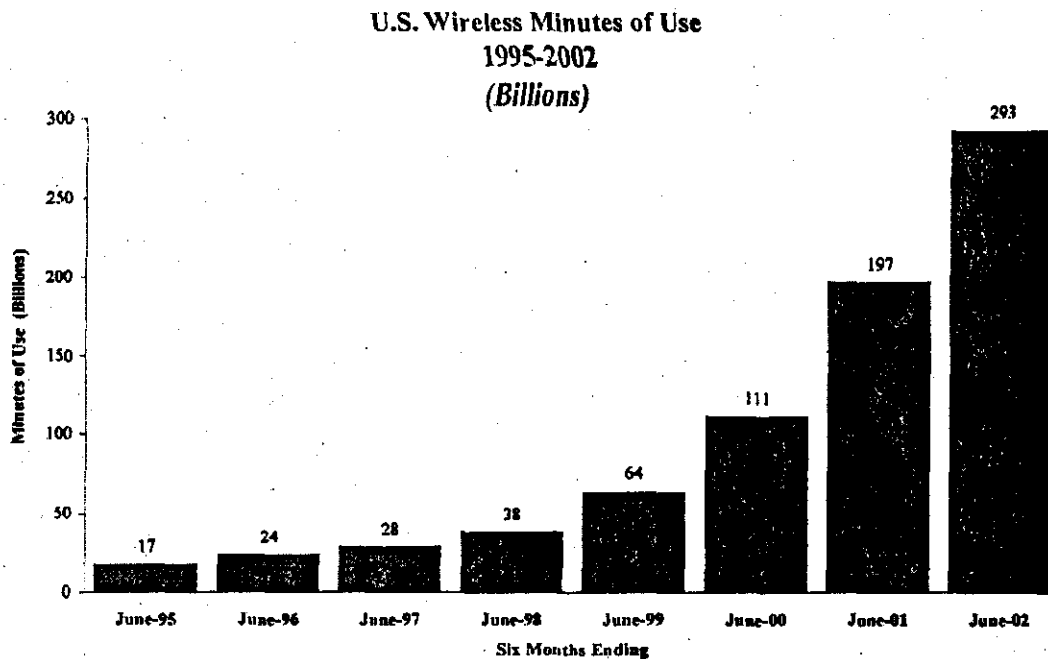
21. With shares measured on a revenue basis, the HHI for wireline services in 1995 was roughly 3,400. Revenue-based forecasts for wireline long distance shares for 2005 are not available. However, to the extent that BOCs have been successful in attracting AT&T subscribers, who typically generate below-average revenue per subscriber, then the revenue-based HHI for 2005 would be expected to be below the reported subscriber based figure.

2. Wireline long distance service faces substantial and growing competition from wireless services and new technologies

28. Standard measures of subscriber shares and concentration based on wireline subscribers overstate the concentration of long distance services and implicitly understate the increase in competition in recent years. This is because wireline long distance services now face substantial competition from wireless services, e-mail and instant messaging. These services were in their infancy in 1995, but have contributed to a substantial loss in long distance minutes carried on wireline networks in recent years. In the current environment, a unilateral attempt by an ILEC to raise prices charged for long distance would be expected to result not only in a loss of customers to rival wireline providers but also a substantial loss in minutes of long distance calling time to other service "platforms."

29. The penetration of wireless services has grown with extraordinary speed in recent years. Between June 1995 and June 2002, the number of subscribers to wireless services in the United States increased by nearly 400 percent, from 28 million to 135 million. Total wireless minutes of use increased even more dramatically over this period. Between 1995 and 2002, total wireless minutes of use increased by more than 1,600 percent. (See Figure 3.)

Figure 3:



Source: CTIA's Wireless Industry Indices, December 2002, pp. 202-203.

30. The emergence of new pricing mechanisms in wireless service plans has contributed to rapid growth in the use of wireless services for long distance calls. These include "bucket" plans (which offer a given number of minutes for a flat monthly rate) that effectively reduce the marginal costs of long distance calls to zero for many consumers. Recent analyst reports focus on substitution between wireline and wireless long distance use:

[W]ith changes in wireless pricing – more bucket plans with huge (or unlimited) bundles of night and weekend minutes, including long distance – there is growing evidence that wireless is starting to have more and more of an impact on the wireline telecom service providers.²²

Wireless MOU cannibalization has been particularly fierce in recent years as the bucket pricing is essentially giving away free long distance during the primary "consumer" hours (after 9PM and on weekends). We expect this to continue...²³

22. Merrill Lynch, "Wireless Svc: Landline Substitution Becoming More Meaningful," April 22, 2002, p. 3.

23. Lehman Brothers, "AT&T," November 18, 2002, p. 4.

31. The Cellular Telecommunications Industry Association (CTIA) estimates that in 2002 interstate long distance calls accounted for nearly 25 percent of wireless traffic.²⁴ This, in turn, implies that wireless service accounts for roughly 29 percent of originating interstate long distance traffic.²⁵

32. It is also widely recognized that e-mail and instant messaging provide a substitute for certain long distance calls. These forms of communication were used little if at all in 1995, but now account for billions of messages daily.

- The number of adults online, and thus with access to e-mail and instant messaging, increased from 17.5 million in 1995 to 137 million in 2002.²⁶ The number of high speed Internet lines increased from 2.8 million in December 1999 to nearly 20 million in December 2002.²⁷
- Estimates of the number of e-mail messages vary widely. According to one conservative estimate, the number of e-mail messages sent in the U.S. and Canada were expected to nearly triple between 2000 to 2003, from 6.1 billion per day to 13.7 billion per day.²⁸

24. Wireless Carrier Interstate Traffic Studies, presented in a letter from Michael Altschul of CTIA to the FCC, September 30, 2002.

25. This figure is calculated using data on total wireless minutes of use, inbound and outbound wireless calls, interstate switched access minutes, dial equipment minutes and total voice traffic reported in the CTIA's December 2002 Wireless Industry Indices survey, along with data from a CTIA survey of wireless long distance usage of five national carriers as presented in a letter from Michael Altschul of the CTIA to the FCC, September 30, 2002. The calculation assumes that the share of landline call volume that respectively terminates with (i) landline and (ii) wireless subscribers is equal to the shares of landline and wireless minutes.

26. http://cyberatlas.internet.com/big_picture/geographics/article/0,,5911_1011491,00.html (Nielsen Cyberatlas).

27. FCC, High-Speed Services for Internet Access: Status as of December 21, 2002, June 2003, Table 1

28. International Data Corporation data, eMarketer, April 23, 2001.

- In addition, instant messaging services are becoming more attractive alternatives for long distance calls. For example, Microsoft and Apple have both released test versions of their instant messaging software that incorporate both voice and video. The final Microsoft version is expected to be available free of charge, while the Apple version will be available free with Apple's new operating system.²⁹

33. The explosive growth in wireless services and e-mail has resulted in a substantial decline in wireline long distance usage in recent years, despite substantial declines in retail prices (which are discussed below). For example:

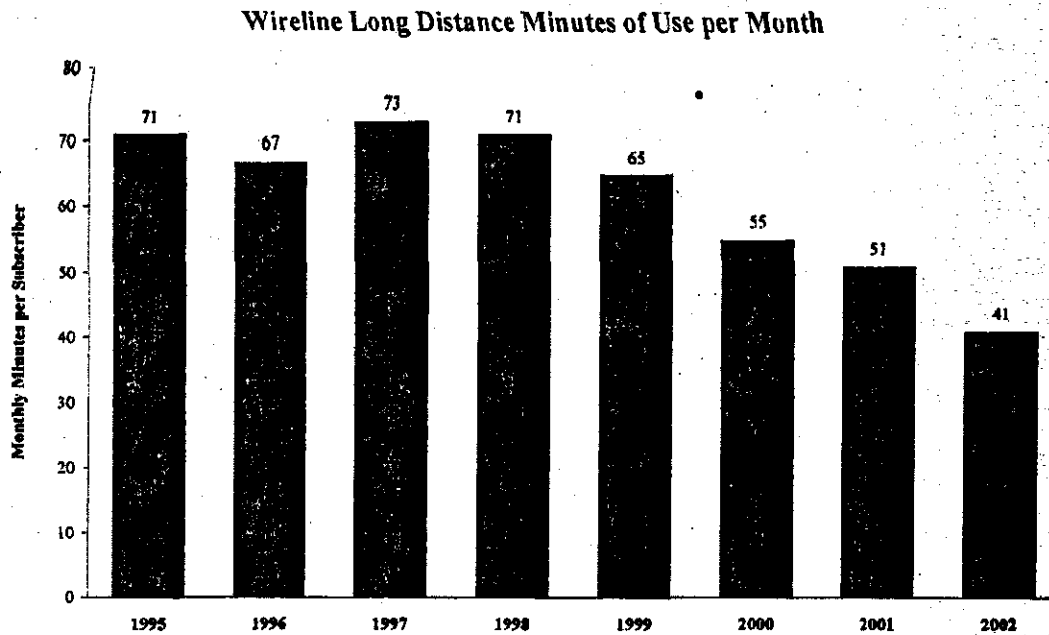
- As shown in Figure 4, FCC data indicate that the average wireline interLATA interstate usage fell from 71 minutes per month in 1995 to 41 minutes per month in 2002, a decline of 42 percent.³⁰
- As summarized in a recent Merrill Lynch analyst report, "[w]hereas two years ago an average wireline consumer LD customer made seven calls per week averaging eight minutes per call, now that same customer makes five calls a week averaging somewhat more than seven minute per call."³¹

29. David Pogue, "Video Chat Software Revisited," New York Times, June 26, 2003.

30. FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 20.

31. Merrill Lynch, "Wireline Services: Landline Substitution: Becoming More Meaningful," April 22, 2002, p. 2.

Figure 4:



Source: FCC's Statistics of the Long Distance Telecommunications Industry, May 2003, p. 37.

Note: Wireline long distance data reflect interLATA interstate calls.

34. Analysts estimate that the growth of wireless services and the Internet account for an even larger reduction in traffic carried by wireline long distance service providers than losses due to the entry of BOCs into the provision of long distance service.

- According to Lehman Bros., AT&T's consumer business lost roughly \$3.5 billion in revenue between 2001 and 2002. They estimate that "70% of that is due to wireless and Internet substitution (email etc.)" and that competition from BOCs accounts for "less than a third of the total."³²
- According to Merrill Lynch, "[w]ireless is evidently driving a substantial migration of LD minutes (impacting RBOC switched access minutes of use). AT&T ... indicated that consumer long distance calling volumes in 4Q02

32. Lehman Brothers, "AT&T," November 18, 2002, p. 4.

declined at a low double-digit rate driven by competition and a continued substitution.”³³

- Merrill Lynch also reports that Sprint’s “consumer LD voice volumes for wireline subscribers were down 10% YoY [year over prior year]. Sprint apportioned 75% of the impact to wireless substitution and the remaining 25% to email traffic. We estimate that AT&T’s consumer LD revenue will decline 25% YoY in 2002, with more than half of the decline coming from wireless. ... Clearly, people are not talking less, and we believe the majority of these ‘lost’ wireline minutes are in fact moving over to wireless.”³⁴

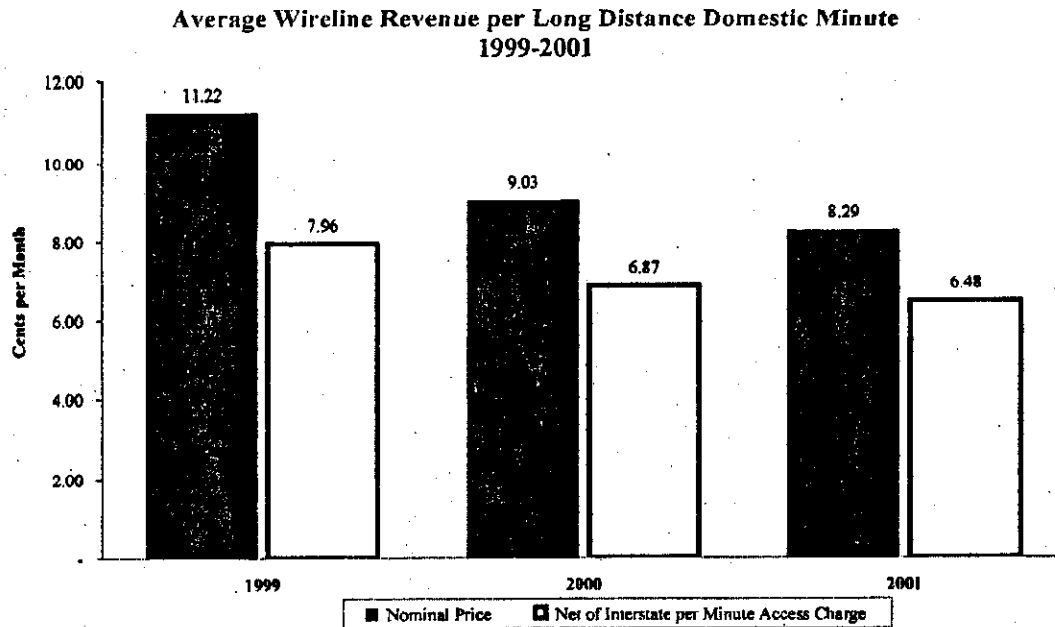
3. Long distance prices and spending have declined in recent years

35. Not surprisingly, the increases in long distance competition in recent years have resulted in declining prices. As shown in Figure 5, FCC data indicate that average revenue per minute for interstate long distance calls with wireline carriers fell from 11.2 cents per minute in 1999 to 8.3 cents per minute in 2001, the most recent data available. Net of minute-based access charges, average long distance prices fell from 8.0 cents per minute in 1999 to 6.5 cents per minute in 2001.

33. Merrill Lynch, “BellSouth Corp.”, January 27, 2003, p. 5.

34. Merrill Lynch Capital Markets, “Wireless Svc: Landline Substitution: Becoming More Meaningful.” April 22, 2002, p. 3.

Figure 5:

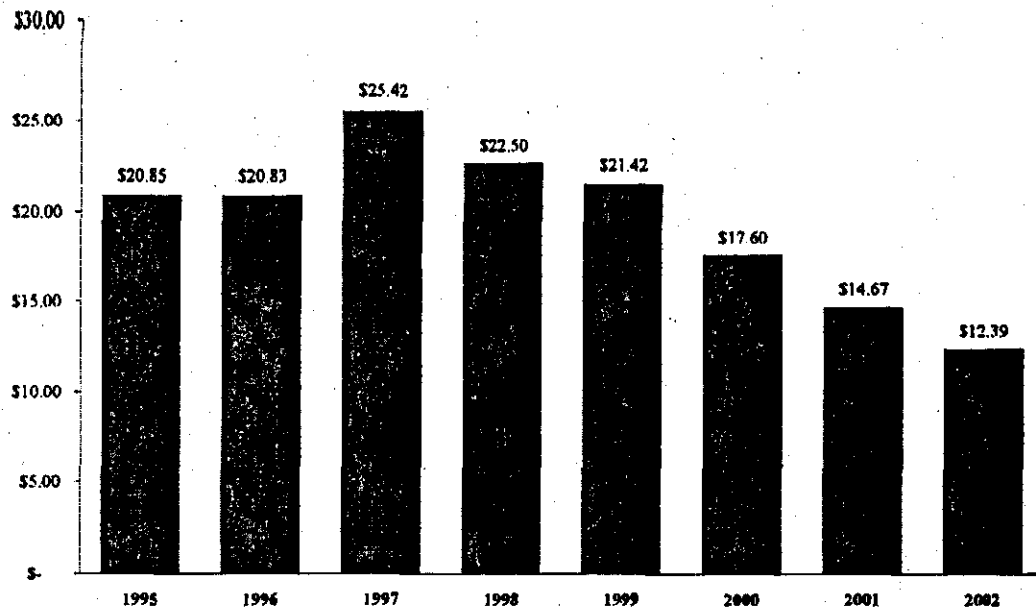


Source: FCC's Statistics of the Long Distance Telecommunications Industry, May 2003, Table 5;
Trends in Telephone Service, May 2002, Table 1.2.

36. The combination of the decline in price and the decline in long distance usage described above, has resulted in a large decline in consumer long distance spending in recent years. As shown in Figure 6, average monthly household spending on long distance carriers fell from \$20.85 in 1995 to \$12.39, a decline of nearly 40 percent. In inflation-adjusted terms, the decline is even larger, approximately 50 percent.

Figure 6:

Average Monthly Household Wireline Long Distance Spending



Source: FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 13.

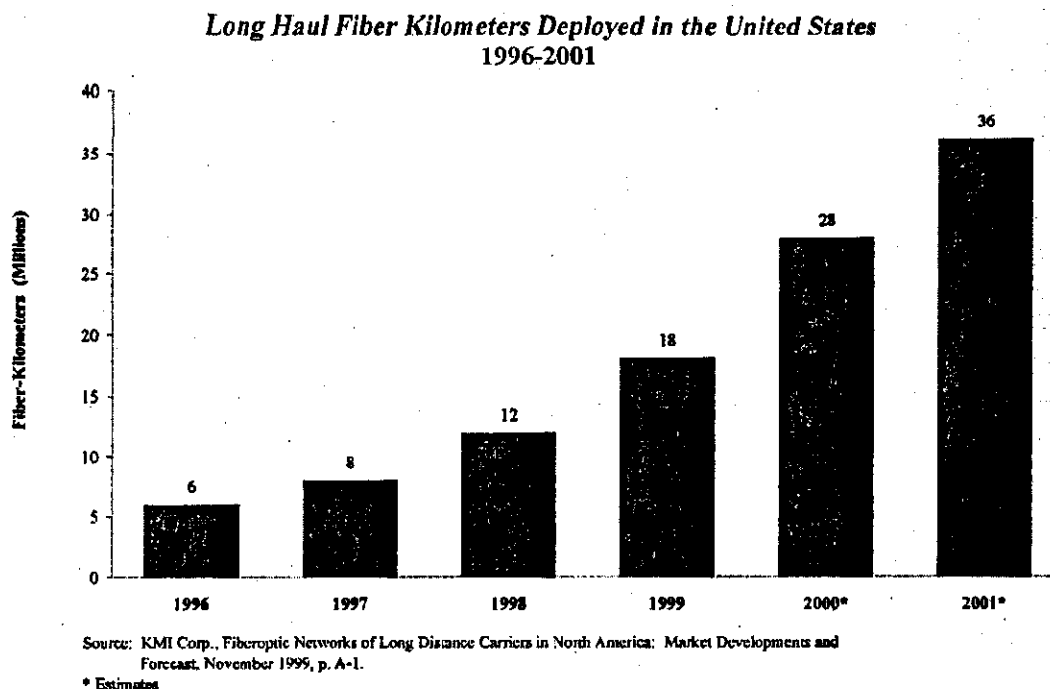
4. There has been a massive increase in transmission capacity in recent years.

37. The FCC's 1995 AT&T Non-Dominance Order stressed that there is capacity available for industry expansion and that long distance carriers have the ability to do so.³⁵ Since that time, there have been massive increases in fiber optic capacity throughout the United States as several new, national fiber optic networks have been deployed.

38. According to 1999 estimates, the number of fiber-kilometers of fiber optic cable deployed in the United States was expected to increase from 5.9 million in 1996 to 35.9 million in 2001. (See Figure 7.) This includes new networks deployed by Qwest, Level 3, Williams, IXC, and a variety of others as well as expansion by existing network providers. As is widely recognized, this massive expansion produced a "glut" that resulted in a number of bankruptcies. Nonetheless, this fiber capacity remains in place leaving existing carriers and entrants the ability to rapidly expand.

35. AT&T Non-Dominance Order, ¶58.

Figure 7:



39. Even the growth in fiber deployment implicitly understates the increase in telecommunications capacity due to the continuing development of electronics capable of carrying larger amounts of information in a given optical fiber. For example, in the FCC's 1998 MCI WorldCom Order, the FCC noted that new network technologies, such as Dense Wave Division Multiplexing (DWDM) alone were expected to allow a 100-fold increase in U.S. fiber backbone capacity between 1997 and 2000.³⁶ Since that time, new network technologies permit even greater increases in capacity. In 1998, Ciena's DWDM equipment transmitted up to 240 Gb/s.³⁷ The current version of Ciena's DWDM product transmits up to 1.6 Tb/s, more than a six-fold increase.³⁸

36. FCC, MCI WorldCom Order, FCC 98-225, September 14, 1998, ¶64.

37. Ciena Press Release, "Sprint Increases Network Capacity, Performance with Deployment of Ciena's Scaleable 40-Channel Multiwave 4000," March 16, 1998.

38. Ciena CoreStream Dense Wavelength Division Multiplexing System, <http://www.ciena.com/products/transport/longhaul/corestream/index.asp>.

40. In discussing the increase in the capacity of new telecommunications equipment, the FCC concluded in its 1998 MCI WorldCom order that "[a]s a result, existing carriers can expand capacity to constrain a unilateral exercise of market power by any other carrier, and new carriers likely will be able to constrain any coordinated exercise of market power by the incumbents."³⁹

5. Long term industry trends toward increased competition are expected to continue

41. While the long distance industry continues to respond to the entry of BOCs and the growth of intermodal competition from wireless services and e-mail, additional changes -- such as Voice over Internet Protocol (VoIP) and bundling of local and long distance services -- are starting to bring yet more competition to the industry.

42. For example, new services using "Voice Over Internet Protocol" (VoIP) technology have been introduced. These services promise to deliver another alternative to the wireline long distance (and local) networks by using the Internet to carry voice messages. FCC Chairman Powell noted that "... 2002 saw the introduction of reliable Internet telephony services as companies such as Vonage are providing an alternative to analog wired telephony over a broadband connection."⁴⁰

43. VoIP services are also expected to speed deployment of cable telephony, resulting in further intermodal competition for wireline long distance suppliers. Cox, Cablevision, Time Warner and Comcast have all begun trials of VoIP based telephone service.⁴¹ Deutsche Bank highlights the VoIP's potential significance in promoting cable telephony:

39. FCC, MCI WorldCom Order, ¶64.

40. Written Statement of Michael Powell before the Committee on Commerce, Science, and Transportation, United States Senate, January 14, 2003.

41. Morgan Stanley, "Industry Report, Wireline Telecom Services -- Trend Tracker: Bottom Line Better," May 23, 2003, p. 16.

We maintain our view that cable telephony, as well as a more broadly-defined "triple-play" bundle, represents the greatest longer-term threat to wireline operators. ... Although the [cable] industry has waited on VoIP for a good part of the last decade, it appears highly likely that a competitive product could finally emerge sometime in late 2003 or early 2004. Thus, in 2005, the operating incentive could easily catch-up with technology, providing cable operators with both the opportunity and means to become a force in the telecom industry.⁴²

44. As this example suggests, there is every indication that the dramatic and pro-competitive changes in industry conditions observed since the FCC declared AT&T to be a non-dominant carrier in 1995 are continuing. Morgan Stanley, for example, recently concluded that "[w]e expect the long distance industry to continue its free-fall as the twin forces of excessive competition and lack of demand continue indefinitely."⁴³

IV. EXPIRATION OF STRUCTURAL SEPARATION RULES WOULD NOT ENABLE ILECS TO HARM COMPETITION BY MANIPULATING ACCESS TO THEIR LOCAL NETWORKS

45. As noted above, the FNPRM asks for comments on various theories which have been raised by ILECs' long distance rivals, who suggest that expiration of structural separation requirements would enable ILECs to harm competition by (i) engaging in non-price discrimination in providing local network access to rival long distance suppliers;⁴⁴ (ii) engaging in a "price squeeze" designed to drive their rival long distance carriers from the market; and (iii) shifting costs from their long distance subsidiaries to local business units.⁴⁵ We find that there is

42. Deutsche Bank, "Wireline - Mid Year Review: Last Man Standing," May 27, 2003, p.27.

43. Morgan Stanley, "Wireline Telecom Services - Trend Tracker: Bottom Line Better," May 23, 2003, p. 7.

44. "We also seek comment on whether allowing BOCs and independent LECs to provide interexchange service on an integrated basis will diminish the ability of regulators and interexchange competitors to detect such discrimination." FNPRM, ¶31.

45. "We seek comment on the incentives and abilities of these carriers to misallocate their costs, discriminate, and engage in predatory price squeezes to such an extent that they may increase their market share and attain market power in the interstate and international interexchange markets. ... We ask whether the carriers' incentives and abilities increase if they provide interstate and international interexchange services on an integrated basis." FNPRM, ¶29.

no basis for each of these concerns. Moreover, as discussed in Section V below, even if such concerns existed, dominant carrier regulations are ill-suited to address them.

**A. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS
WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO
ENGAGE IN NON-PRICE DISCRIMINATION AGAINST RIVALS IN
PROVIDING NETWORK ACCESS**

46. The incentive and ability for ILECs to engage in non-price discrimination in providing rival long distance carriers access to local telephone networks depends on the ability of long distance firms and regulators to detect such actions as well as the penalties that result if discrimination is detected. Expiration of the structural separation requirements, however, affects only how ILECs structure their internal operations, not their incentive or ability to engage in non-price discrimination.

47. In order for discrimination to succeed, it must be effective enough to cause customers to switch to ILEC long distance services from those provided by other firms but, at the same time, must avoid detection by regulators and sophisticated rivals, such as AT&T, Sprint and MCI. These firms operate nationally and thus have numerous benchmarks available to evaluate whether an individual ILEC is engaging in non-price discrimination.

48. There is no basis to conclude that elimination of structural separation rules would alter ILECs' incentive to engage in non-price discrimination. For example, elimination of structural separation rules does not reduce the penalties associated with discrimination, which include fines, the potential loss of the authority to provide long distance services, and exposure to antitrust penalties.

49. In addition, a variety of other regulatory safeguards against unreasonable non-price discrimination by ILECs against long distance rivals would remain in effect following expiration of structural separation requirements. These include:

- Equal access requirements (to the extent the Commission determines they remain necessary) and non-discrimination provisions of Section 251 of the Telecommunications Act;⁴⁶
- Nondiscrimination requirements under Sections 201 and 202 of the Telecommunications Act;⁴⁷
- Prohibitions on discrimination under various state statutes.⁴⁸

50. Moreover, the reporting requirements imposed on BOCs to measure their provision of access services remain in effect after expiration of the separate subsidiary requirements. These include BOCs' obligations to disclose "network changes affecting competing service providers' performance or ability to provide telecommunications services, as well as changes that would affect the incumbent LEC's interoperability with other service providers."⁴⁹ ILECs also are subject to rigorous measurements that detail their performance in providing unbundled network elements, interconnection and related services.⁵⁰

B. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO PURSUE A PREDATORY "PRICE SQUEEZE"

51. The FNPRM requests comment on whether expiration of structural separation requirements would increase ILECs' incentive or ability to harm competition by engaging in a predatory "price squeeze."

52. A predatory "price squeeze" is said to occur when an ILEC sets retail prices for long distance service that are sufficiently near (or even below) the prices it charges its long

46. See FCC, Non-Accounting Safeguards Order, 11 FCC Rcd. 21905, December 24, 1996, ¶271.

47. *Id.*, ¶211.

48. *Id.*, footnote 509.

49. *Id.*, ¶208.

50. See, for example, FCC, Qwest 271 Order for Minnesota, FCC 03-142, June 26, 2003, ¶10, Appendices B and C (performance measures).

distance rivals for access to its local network that equally efficient rivals will be driven from the market. This can be accomplished by an ILEC lowering its retail long distance prices, raising access prices charged to its long distance rivals, or both.

53. A price squeeze is a competitive concern if it is used to predate. In pursuing this strategy the ILEC sacrifices revenue with the goal of driving its rivals from the market and later recouping its investment in the form of higher retail prices. However, there is no basis for concern that expiration of the structural separation requirement will affect ILECs' incentive or ability to pursue a predatory "price squeeze."

54. The foremost reason is that it is widely recognized that predation is rarely a profitable strategy.⁵¹ As noted above, firms that engage in predation incur some short-run losses in order to obtain longer-term gains. In order for predation to be successful, it is essential that attempts by the surviving firm to raise price (after driving its rivals from the market) do not result in entry. If entry occurs, firms will not be able to sustain the increase in price necessary to make predation a profitable strategy.

55. It is highly unlikely that a predatory strategy would succeed in the long distance industry. First, the industry includes several large, well-established rivals which include both wireline long distance carriers and wireless service providers. In addition, much industry investment consists of fixed assets, such as copper plant, fiber optic plant, switches and other equipment. These assets are likely to remain available to a new entrant, even if existing long distance companies are driven from the market. Thus, it would be difficult for a firm engaging

51. See, for example, D. Carlton and J. Perloff, Modern Industrial Organization, Third Edition, pp. 334-342, which concludes (p. 342): "Given all the theoretical difficulties with successful predatory pricing, it is not surprising that economists and lawyers have found few instances of successful price predation in which rivals are driven out of business and prices then rise."

in predation to prevent firms from entering the industry by purchasing these assets after the predator attempted to raise price in order to recoup its investment.⁵²

56. The current bankruptcies in the telecommunication industry highlight this point. In particular, the assets of firms now in bankruptcy firms typically have not exited the industry. Instead, bankrupt telecommunications firms (such as MCI WorldCom) are expected to remain in the industry and to emerge as effective competitors (with greatly reduced debt). As Morgan Stanley summarizes:

As the monthly operating results demonstrate, WorldCom is alive and competing. The company at the very least will re-emerge and try to give it a go. In an environment of limited demand and a possible shrinking pie in 2003, Sprint and AT&T have to contend with WorldCom's continuing seat at the table.⁵³

57. Even if an ILEC could eliminate competition through predatory pricing, it is unlikely that the ILEC would be able to recoup its losses because it would likely face re-regulation as the result of its new monopoly status. In addition, it could face large penalties under antitrust laws. Thus, it is highly unlikely that ILECs could ever recoup investments in predation and thus it is highly unlikely that any such strategy would be pursued.

58. In any event, there is no basis to conclude that elimination of structural separation requirements has any impact on the ability of the Commission or ILECs' long distance rivals to scrutinize ILEC pricing and detect predation.

**C. EXPIRATION OF STRUCTURAL SEPARATION REQUIREMENTS
WOULD NOT ENHANCE ILECS' INCENTIVE OR ABILITY TO
ENGAGE IN COST SHIFTING**

59. The FCC has also expressed concern about an ILECs' ability to shift costs from its long distance division to its local service subsidiary. The FCC discusses two potential

52. The FCC recognizes this point in LEC Non-Dominance Order, ¶107.

53. Morgan Stanley, Wireline Telecom Services – Trend Tracker: Bottom Line Better, May 23, 2003, p. 31.

concerns: (i) cost shifting may be used to facilitate a price squeeze; and (ii) cost shifting may be used to evade regulation and raise the price of regulated services.⁵⁴ This section shows that there is no basis for either concern.

1. Expiration of structural separation requirements will not enable ILECs to engage in predatory conduct by improperly shifting costs

60. For the purposes of determining whether an ILEC is to be classified as a "dominant" long distance carrier, the FCC has previously recognized that the only relevant issue is whether cost shifting can be used to facilitate predation and drive rival long distance carriers from the market.

For purposes of determining whether the BOC interLATA affiliates should be classified as dominant, however, we must consider only whether the BOCs could improperly allocate costs to such an extent that it would give the BOC interLATA affiliates ... the ability to raise prices by restricting their own output. We conclude that, in reality, such a situation could occur only if a BOC's improper allocation enabled a BOC interLATA affiliate to set retail interLATA prices at predatory levels (i.e., below the costs incurred to provide those services), drive out its interLATA competitors, and then raise and sustain retail interLATA prices significantly above competitive levels.⁵⁵

61. There is no basis for concern that the expiration of structural separation requirements would enable ILECs to engage in predatory conduct by improperly shifting costs from long distance to local operations. This is because there is no logical connection between a firm's ability to shift costs and its incentive or ability to pursue a predatory strategy.

62. As discussed above, predation requires a firm to sacrifice profits (relative to the level that otherwise would prevail) during the period in which its rivals are driven from the

54. The FCC summarizes this concern in its LEC Non-Dominance Order (¶103): "[I]mproper allocation of costs by a BOC is of concern because such action may allow a BOC to recover costs from subscribers to its regulated services that were incurred by its interLATA affiliate in providing competitive interLATA services. In addition to the direct harm to regulated ratepayers, this practice can distort price signals in those markets and may, under certain circumstances, give the affiliate an unfair advantage over its competitors."

55. FCC, LEC Non-Dominance Order, ¶103.

market. In the unlikely event that such a strategy was profitable, the firm could finance its "investment" in a number of ways, including using earnings from a structurally separate subsidiary or even through borrowing in financial markets. A firm's ability to shift costs is not necessary to "fund" predatory conduct. Nonetheless, for reasons described above, it is very unlikely that any predatory strategy could succeed in the telecommunications industry, and thus it is unlikely that any would be attempted.

2. It is unlikely that expiration of separate subsidiary rules will enable ILECs' to evade regulation by shifting costs

63. It is unlikely that expiration of structural separation rules would give firms the incentive or ability to evade regulation by shifting significant costs from their long distance to local operations. As noted above, the FCC acknowledges that the evasion of regulation alone does not raise competitive concerns unless it is likely to give rise to predation -- which is highly unlikely in this industry. Furthermore, as discussed below, application of dominant carrier is inappropriate for addressing concerns that ILECs can evade regulations by shifting costs.

64. Nonetheless, it is important to note there is now little if any incentive for integrated carriers to avoid regulation by shifting costs because prices for regulated rates for local services, including exchange access and local exchange services, are largely set independently of the costs reported by ILECs. If shifting costs from long distance to local operations does not enable firms to generate higher revenue through higher prices of regulated services, there is no incentive to do so.

65. For example, interstate access charges today are governed by the CALLS order (Coalition for Affordable Local and Long Distance Service).⁵⁶ Under this order, a five-year

56. FCC, Order in the Matter of Access Charge Reform Price Cap Performance Review for Local Exchange Carriers Low-Volume Long Distance Users Federal-State Joint Board On Universal Service, CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 99-249, CC Docket No. 96-45, May 31, 2000.

schedule of access rates was established that lowered traffic-specific rates to \$.0055 per minute with further adjustments over time based on productivity trends.

66. Furthermore, prices for local exchange services and intrastate access services are subject to price cap formulas or other forms of incentive regulation and thus are not directly affected by changes in reported costs. For example, a number of states simply apply the CALLS rate for interstate access charges in setting intrastate access charges. While price cap and incentive regulation formulas differ from state to state, such regulations lessen or eliminate the relationship between an ILEC's reported costs and the prices it can charge for regulated services. According to a June 20, 2003 Communications Daily white paper, nearly all states use price caps, revenue caps or related forms of incentive regulation.⁵⁷ Only six states, which account for roughly five percent of the U.S. population, continue to regulate BOCs using rate of return regulation (although additional states continue to use rate of return regulation to regulate some independent ILECs). Even in states where rate of return regulation is still used, however, regulators can look to areas where price caps are used as benchmarks in establishing regulated rates, as well as other regulatory safeguards.

D. ELIMINATION OF SEPARATE SUBSIDIARY REQUIREMENTS FOR OTHER ILEC BUSINESSES HAS NOT RESULTED IN HARM TO COMPETITION

67. Available evidence indicates that removal (or absence) of structural separation requirements for various ancillary ILEC businesses has not adversely affected competition. These experiences provide no basis for concern that expiration of structural separation requirements relating to ILECs' long distance will harm consumers.

57. "Retail Rate Regulation of Local Exchange Providers in the U.S.," Special White Paper Supplement to Communications Daily, June 20, 2003.

68. In the past, the FCC required that ILECs provide a variety of ancillary services, including customer premises equipment (CPE) and enhanced services, through separate subsidiaries. The FCC's concerns motivating these restrictions were similar to those discussed in the FNPRM with respect to ILEC provision of long distance services. In the Computer III order in 1986, the FCC summarized concerns that motivated the structural separation requirements:

We were particularly concerned that major carriers could use their control over basic services to discriminate against others' competitive services and products. We were also concerned that these carriers could misallocate costs from unregulated to regulated activities, allowing them to impose unfair burdens on regulated ratepayers and improperly cross-subsidize their competitive offerings.⁵⁸

69. The FCC later removed these structural separation requirements relating to CPE and enhanced services after concluding that the costs of such restrictions outweighed their benefits, concluding that nonstructural safeguards were sufficient to address their concerns.

We conclude that in light of the high costs of mandatory structural separation the public interest would be better served by providing the BOCs with more flexibility in organizing their CPE and network services operations, while relying on effective, alternative methods to prevent improper cross-subsidization and discrimination.⁵⁹

70. At the time that structural separation requirements were eliminated in 1987, rate of return regulation was prevalent and there were much stronger incentives than today for ILECs to engage in cost shifting. Nonetheless, we are aware of no evidence (or even claims) of competitive harm from the elimination of the structural separation requirements relating to CPE and enhanced services more than 15 years ago.

71. In addition, the FCC previously allowed separate subsidiary requirements relating to ILEC provision of interLATA information services to expire⁶⁰ and has permitted ILECs to

58. FCC, Computer III Order, 104 FCC 2d 958, June 16, 1986, ¶12.

59. BOC Structural Relief Order, 2 FCC Rcd. 143, January 12, 1987, ¶2.

60. FCC, Order in the Matter of Request for Extension of the Sunset Date of the Structural, Non-Discrimination and other Behavioral Safeguards Governing Bell Operating Company Provision of In-Region, InterLATA Information Services, FCC 00-40, February 8, 2000.

provide intraLATA toll services on an integrated basis with local services. The non-price discrimination, price squeeze and cost shifting concerns raised by the FCC in the FNPRM regarding long distance services would seem to equally apply to these services. We are unaware of any evidence that expiration of these rules has adversely affected competition in the provision of these services.

V. IMPOSITION OF DOMINANT CARRIER REGULATION WOULD NOT ADDRESS THE FCC'S STATED CONCERNS AND WOULD HARM CONSUMERS

72. The FNPRM asks whether, and to what extent, dominant carrier regulation of interstate interexchange services is suited to achieving the Commission's objectives. In its notice, the FCC recognizes that dominant carrier regulation -- which could require ILECs to file tariffs and may subject ILEC long distance service to retail price cap regulation -- is not well suited to addressing the competitive concerns that have been raised:

[t]he regulatory requirements on a carrier classified as dominant in a particular market generally are designed to prevent a carrier from raising prices by restricting its output rather than to prevent a carrier from raising its prices by raising its rivals' costs; therefore, application of these regulations to a carrier that does not have the ability to leverage its market power by restricting its own output could lead to incongruous results.⁶¹

73. The Commission's evaluation of the limitations of dominant carrier regulation in addressing its concerns is well founded. Given the current status of the long distance industry and existing safeguards, the imposition of dominant carrier regulation would not only be inappropriate, but would impose unwarranted costs and distortions on the industry.

A. THE FCC'S COMPETITIVE CONCERNS ARE NOT ADDRESSED BY DOMINANT CARRIER REGULATION

74. As discussed earlier, the FCC has expressed concerns about the extent to which sunset of structural separation rules would enable ILECs to engage in non-price discrimination or

61. FNPRM ¶38.

predation against their long distance rivals. While we conclude above that there is no basis for these concerns, even if there were, dominant firm regulation would not address them.

75. First, tariffs and price caps would not address concerns about non-price discrimination by ILECs against their long distance rivals. As discussed above, the incentive and ability of ILECs to engage in non-price discrimination depends critically on the ability of customers, rivals and regulators to detect it. As noted earlier, successful discrimination requires that these actions be noticeable to consumers (in order to induce them to switch to ILEC-supplied services) but must escape notice by competitors and regulators.

76. However, neither tariffs nor price caps affect the ability of consumers, rivals or regulators to detect non-price discrimination.⁶² Even if an ILEC could engage in non-price discrimination against a competitor, regulation of the ILEC's long distance prices would not affect its ability to do so. As discussed earlier, regulators and long distance providers now have many years of experience in monitoring ILEC obligations with equal access and other non-discrimination requirements and the national scope of the major long distance companies leaves them numerous benchmarks for evaluating the performance of a given ILEC in providing interconnection with their local networks.

77. Second, price caps and tariffs would not address predation concerns. As discussed earlier, successful predation requires that a firm accept short-term losses while driving its rivals from the market. However, dominant carrier regulations would not prevent this conduct. As noted above, the FCC recognizes that tariff requirements and/or price cap regulations are typically intended to prevent companies from setting prices that are considered too high, not to prevent firms from lowering prices. If tariffs or price caps were to deter firms

62. Instead, tariffs or price cap regulation, at best, may deter a BOC from raising price if discrimination was successful. (LEC Non-Dominance Order ¶87)